

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

AN ADJUSTMENT OF ELECTRIC)	
RATES OF THE UNION LIGHT,)	CASE NO. 9299
HEAT AND POWER COMPANY)	

O R D E R

On April 10, 1985, the Union Light, Heat and Power Company ("ULH&P") filed notice with the Commission requesting to increase its rates and charges for electric service. The Commission issued its Order in this case on October 3, 1985. On October 23, 1985, ULH&P filed its petition for rehearing with the Commission requesting reconsideration of certain issues in the Commission's Order. On November 11, 1985, the Consumer Protection Division in the Office of the Attorney General ("AG") filed a response to ULH&P's petition. The issues raised by ULH&P and the AG are addressed in the following paragraphs.

ULH&P'S PETITION FOR REHEARING

ULH&P contested the Commission's Order on the following issues: The Effects of the Exclusion of the Buffington Substation from Rate Base; Fuel Synchronization; Capital Structure; Return on Equity; Debt Charges; Advertising Expense; Recovery of Administrative Costs in Cogeneration and Small Power Production Tariffs.

Exclusion of Buffington Substation from Rate Base

ULH&P claims that the Commission erred when it excluded \$1,099,237 for a transformer in the Buffington Substation from rate base and when it correspondingly reduced depreciation expenses by \$31,877. In its petition, ULH&P presented evidence which indicates that this issue should be further considered by the Commission. Therefore, the Commission finds it appropriate to grant rehearing on this issue and to permit ULH&P to file any additional testimony it deems appropriate within 30 days from the date of this Order.

Capital Structure

In its petition for rehearing, ULH&P claimed it had no indication the Commission would adopt Cincinnati Gas and Electric Company's ("CG&E") consolidated capital structure.¹ However, on July 17, 1985, the Commission issued an Order outlining the issues in the case (item 23 was the appropriate capital structure). ULH&P was put on notice that the appropriate capital structure would be an issue. In ULH&P's last rate case (An Adjustment of Gas Rates of the Union Light, Heat and Power Company, Case No. 9029), Mr. Mosley proposed CG&E's consolidated capital structure.² The Commission found that capital structure to be reasonable. In the current rate case, the burden was on ULH&P to convince the Commission that a capital structure containing 50.5 percent equity was reasonable for an electric transmission company. The

¹ Application of ULH&P for Rehearing, p. 12.

² Mosley Testimony, Case No. 9029, p. i.

Commission was unconvinced and concluded that CG&E's consolidated capital structure (containing 37.28 percent equity) was appropriate and reasonable. ULH&P presented no new evidence in its petition for rehearing. Therefore, the Commission denies ULH&P's petition for rehearing on the issue of the appropriate capital structure (item no. 7).

Return on Equity

In its petition for rehearing, ULH&P stated that the Commission erred in allowing a 15.25 percent return on equity.³ ULH&P was of the opinion that a flotation cost adjustment should have been included in the allowed return on equity.⁴ ULH&P also stated the Commission erred in using CG&E's consolidated cost of capital to fix the appropriate rate of return.⁵ In summary, ULH&P is of the opinion that the Commission did not grant an adequate rate of return.

ULH&P is a virtually wholly-owned subsidiary of CG&E. The Commission found CG&E's consolidated capital structure appropriate; therefore, CG&E's embedded costs for debt and preferred stock are the appropriate costs to apply. Differences in risk between CG&E and ULH&P are accounted for in the allowed return on equity. Mr. Mosley's recommended return on equity included a 5 percent adjustment for flotation costs. However, ULH&P incurs no significant flotation costs because it does not sell stock publicly.

³ Application of ULH&P for Rehearing, p. 2.

⁴ Ibid., p. 3.

⁵ Ibid. p. 2.

Including a flotation cost adjustment compensates ULH&P for a cost that does not exist. The discounted cash flow ("DCF") model provides an approximation of the required return on equity. The Commission is not convinced that "fine tuning" the estimate with a flotation cost adjustment improves the estimate. ULH&P presented no new evidence in its petition for rehearing and the Commission is still of the opinion that a 15.25 percent return on equity is reasonable. Therefore, the Commission denies ULH&P's petition for rehearing on the issues of return on equity and overall cost of capital (items 8, 9 and 10).

Fuel Synchronization

ULH&P requested rehearing on fuel synchronization stating that the Commission had erred in rejecting their proposal and ULH&P submitted a new methodology for the Commission to analyze upon rehearing. The Commission grants rehearing for the purpose of considering the proposed new methodology for fuel synchronization.

Debt Charges

ULH&P contends that the Commission erred in reducing net operating income by \$230,032 to reflect the imputation of interest for income tax purposes using the consolidated capital structure of its parent, CG&E. ULH&P further contends that its actual incurred debt should be used as the basis for computation of income tax expense.

The Commission finds no reasonable basis for ULH&P's argument. For purposes of evaluating risk and the corresponding appropriate rate of return, the Commission found CG&E's capital

structure reasonable and appropriate and based its findings upon that consideration. To maintain proper and consistent rate-making, the same capital structure must be used for each purpose throughout the rate-making process. As CG&E's capital structure was used to evaluate risk and thus resulted in a higher rate of return award, so too must the income tax effect of this treatment be recognized. The income tax effect of the Commission's adjustments to operating expenses and rate base are recognized, and the Commission finds no reason why adjustments to capital structure should not be as well.

Therefore, the Commission continues to be of the opinion that it is proper and necessary to consistently apply one capital structure in the rate-making process for ULH&P and, in this instance, it should be the consolidated capital structure of CG&E. The request for rehearing on this issue is denied.

Advertising Expense

ULH&P contends that the Commission erred when it deducted \$14,717 from test-year operating expenses for area development advertisements promoting enterprise for Northern Kentucky. ULH&P based its contention upon KRS 154.650, the stated purpose of which is to encourage new economic activity by means of reduced taxes and the removal of unnecessary governmental barriers. ULH&P's reliance on this statute is without merit because the action taken by the Commission with regard to advertising expense was clearly necessary for the enforcement of 807 KAR 5:016.

ULH&P's argument seemed premised on the mistaken belief that the Commission was in some way attempting to dissuade utility

companies from area development and the advertising necessary to make it effective. This is not so. The Commission is only determining that the stockholders, not the ratepayers, will be responsible for the expenses as required by 807 KAR 5:016. The Commission denies rehearing on this matter.

Recovery of Administrative Costs in Cogeneration
and Small Power Production Tariffs

In ULH&P's request for rehearing, it asks the Commission to reconsider the company's proposal to include a 5 percent reduction in avoided costs paid to qualifying facilities ("QF") as a means to recover the administrative costs associated with dealing with QFs. In the October 3, 1985, Order in this case, the Commission denied ULH&P's proposal. ULH&P states in its request for rehearing that, if it is prohibited from recovering these administrative costs as proposed, then the company's retail ratepayers will have to bear the burden of paying for such costs and thus the retail ratepayers would be subsidizing the QFs. However, no such subsidy can occur in this case since ULH&P has not identified any specific dollar adjustment as the administrative costs associated with QFs that is to be recovered from retail ratepayers. Thus, the retail ratepayers are not subsidizing the QFs at this time. Further, it should be noted that presently there are no QFs on ULH&P's system, so that even under the company's proposal, no costs for dealing with QFs are being recovered.

The Commission also finds that ULH&P has not provided sufficient support for its proposed 5 percent reduction in the avoided costs it pays to QFs. The Commission, in its June 28,

1984, Order in Case No. 8566, Setting Rates and Terms and Conditions of Purchase of Electric Power for Small Power Producers and Cogenerators by Regulated Electric Utilities, requested ULH&P to provide support for a fixed percentage deduction from avoided cost for administrative cost. ULH&P has not provided any support as to why a 5 percent reduction is any more reasonable than a 10 percent or a 1 percent reduction. Further, it does not seem reasonable that these administrative costs, such as meter reading, bill preparation and payment, and accounting and engineering consultation, will vary in direct proportion to the demand and energy provided by the QF.

Thus, the Commission affirms its original Order that denied ULH&P's proposal to recover the administrative costs associated with QFs by reducing avoided costs by 5 percent.

SUMMARY

Based upon the issues presented in the petition for rehearing and the evidence of record and being advised, the Commission hereby finds that:

1. A rehearing should be granted on the issue of the effects of the exclusion of the Buffington Substation from rate base.

2. A rehearing should be granted on the issue of fuel synchronization.

3. All other issues presented in ULH&P's petition for rehearing should be denied.


4. The Commission's Order of October 3, 1985, requires no modification at this time, pending the outcome of the rehearing.


IT IS THEREFORE ORDERED that ULH&P is granted rehearing on the issues of the effects of the exclusion of the Buffington Substation from rate base, and fuel synchronization as stated in the Commission's Order of October 3, 1985, and that ULH&P shall file any testimony it deems appropriate on these issues within 10 days from the date of this Order.

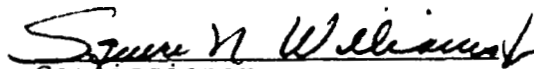
A hearing is scheduled for 9:00 a.m., December 18, 1985, at the Public Service Commission offices. All other issues presented in ULH&P's petition for rehearing be and they hereby are denied.

Done at Frankfort, Kentucky, this 12th day of November, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary